Monetary Policy Regime of Namibia: A Comparison with Hong Kong

By

Fenniyakweni Nangula Shangula

THESIS

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KDI School of Public Policy and Management

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Professor Wook SOHN, Advisor Wook Sohn

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Abstract

The purpose of this paper is to investigate the motivation of the application of a fixed peg exchange rate regime in Namibia and whether they are justified. The motivation for the topic springs from the fact that the 2008 Global Financial Crisis affected Namibia and her dominant partner, South Africa, differently and the monetary tools which Namibia could use to deal with the crisis were constrained because of the fixed exchange rate relationship with South Africa. Thus the question of whether Namibia should continue to exist in a fixed exchange rate relationship with South Africa was brought to the fore. The paper investigates the motives for maintaining the peg by exploring the historical context in which the regime was adopted and the current economic and political environment within which it operates. As the aim is to determine whether academic justifications for using a peg apply to Namibia, said justifications are explored. Furthermore, an investigation of the fixed peg exchange rate regime applied by Hong Kong is conducted, where the historical motivations for pegging the currency to that of the United States are explored as well as why the territory continues to use the same system up to the present. Lastly, the case of Namibia is compared and contrasted against the case of Hong Kong. The main findings of the study show that of the myriad motivations put forth endorsing the use of a fixed exchange rate regime; mainly those of political goodwill (regional integration) and dominant trading partner apply to Namibia. The study also found that although Namibia and Hong Kong have been using the same type of exchange rate system for nearly the same amount of time, the motivations for adopting the system differ slightly and the economic results of such a decision were found to differ in both trend and magnitude for the two regions.

Dedicated to the memory of Elizabeth Shangula

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List of Abbreviations

AU	African Union
BoN	Bank of Namibia
CA	Current Account
CBS	Central Bureau of Statistics
CIA	Central Intelligence Agency
CMA	Common Monetary Area
CPI	Consumer Price Index
FSB	Financial Services Board
GBP	Pound Sterling
GDP	Gross Domestic Product
GER	Germany
GFC	Global Financial Crisis
HKMA	Hong Kong Monetary Authority
IMF	International Monetary Fund
NAD	Namibia Dollar
NAMFISA	Namibia Financial Institutions Supervisory Authority
NETHLS	Netherlands
Repo	Repurchase
RMA	Rand Monetary Area
RSA	Republic of South Africa
SA	South Africa
SACU	Southern Africa Customs Union
SADC	Southern African Development Community
SAR	Special Administrative Region
SARB	South African Reserve Bank
SDR	Special Drawing Rights
STATSSA	Statistics South Africa
SWA	South West Africa
SWITZ	Switzerland
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
UNGA	United Nations General Assembly
US	United States (of America)
USA	United States of America
USD	United States Dollar
ZAR	South African Rand

1. Introduction

According to the IMF, there are currently over 90 countries worldwide which, in one form or another, employ a non-free floating exchange rate regime. Namibia is one such, with the Namibia Dollar pegged to the South African Rand at one-to-one parity.

The Namibian Dollar has been pegged to the Rand for the past two decades without incident and current indications point towards closer regional economic integration. In 2008 the Global Financial Crisis (GFC) brought to the fore discussions regarding the way finance, economics and regulation had thus far been conducted. Discussions turned to debates, and debates turned to arguments. This was because many people, institutions and economies were affected by this global calamity. Namibia did not escape unscathed from the crisis, or the wave of debates- and one of the more robustly debated topic was that of the peg.

The debates surrounding the peg were understandable because the two countries, Namibia and South Africa, were affected to different degrees by the crisis. This expository dissertation will examine the circumstances which engender conditions for a peg and whether, two decades onwards, Namibia still meets the academic criteria.

There are proponents who champion different exchange-rate systems and this study will examine whether the present use of the peg as a monetary policy tool to contain inflation is appropriate for Namibia, especially in the context of national goals such as economic growth, stability and financial market deepening.

Hong Kong, at first glance, appears diametrically different from Namibia. Not only does Hong Kong have a much more sophisticated financial system than Namibia, nothing in the way of people, climate, geography, history or trade suggests that the two have anything in common. However, like Namibia, Hong Kong has been operating under a fixed exchange rate system.

This paper will explore the motivations behind the decision of Hong Kong and compare the case to that of Namibia in order to draw any insights from the experience of Hong Kong.

By way of procession; first a literature review of varying ideas relating to cases for and against different forms of currency regimes will be presented. The literature review section will also touch on the circumstances under which different regimes are best employed. Secondly, the paper will then delve into the relationship between Namibia and South Africa. The case of Hong Kong will be examined next before proceeding with a comparative study of Namibia and Hong Kong. Lastly, the conclusion section.

2. Literature Review

Type of Exchange Rate Regimes

There exist various reasons why a country may opt for a specific type of exchange rate regime. A starting point in determining what regime a country may choose, and why, is an investigation into the various types of exchange rate regimes and the circumstances under which they are commonly employed.

According to Robert C. Feenstra and Alan M.Taylor (2008), exchange rate regimes can be broadly cast into two major categories – fixed and floating.

The authors state that fixed (or pegged) exchange rate regimes are those in which the exchange rate of a country fluctuates in a narrow range, or not at all, against some base currency over a sustained period, usually a year or longer. The exchange rate of a country can remain rigidly fixed for long periods only if the government intervenes in the foreign exchange market in one or both countries.

Mankiw (2009, p350) further expounds on the above definition by stating that "the essence of a fixed-exchange rate system is the commitment of the central bank to allow the money supply to adjust to whatever level will ensure that the equilibrium exchange rate in the market for foreign-currency exchange equals the announced exchange rate. Moreover, as long as the central bank stands ready to buy or sell foreign currency at the fixed exchange rate, the money supply adjusts automatically to the necessary level."

The above author further points out that a fixed exchange rate system fixes the nominal exchange rate, not the real exchange rate, and that in the long run, when prices are assumed to be flexible, fixing the nominal exchange rate would influence only the money supply and the level of prices.

In other words, for the equation:

$$\epsilon = \frac{EP}{P*}$$

where ϵ = real exchange rate

E = nominal exchange rate

P= domestic price level

P = foreign price level*

P and P* are fixed in the short-run only and flexible in the medium and long run. The conclusion to draw from this is that the choice of exchange rate regime does not matter in the long run. The choice of exchange rate regime in the intervening period between the "long" and "short" run is a pertinent one as it will determine how quickly, and with what degree of pain, a country will attain full production.

Conversely, Feenstra and Taylor (2008) claim that floating (or flexible) exchange rate regimes are all the other cases in which a country's exchange rate fluctuates in a wider range, and the government makes no attempt to fix it against any other base currency.

One rule of thumb is to use annual variations in excess of +/- 2% or +/- 1% as the sign of a floating exchange rate.

In order to make the distinctions clearer, Mankiw (2009) points to the Mundell-Fleming Model, which describes the different effects the choice of exchange rate regime has on the effectiveness of policy, namely:

Table 1: The effects of exchange rate on policy

	Floating			Fixed		
	Impact on:					
Policy	**Income**	**Exchange rate**	**Trade Balance**	**Income**	**Exchange Rate**	**Trade Balance**
Fiscal Expansion	No effect	Increase	Decrease	Increase	No effect	No effect
Monetary Expansion	Increase	Decrease	Increase	No effect	No effect	No effect
Import Restriction	No effect	Increase	No effect	Increase	No effect	Increase

Source: (Mankiw 2009, p356)

As is observable from table 1, under a fixed rate regime, an expansive monetary policy decision will have no effect on the income, exchange rate or trade balance level of a country, while under a floating rate regime the same action results in an increase, decrease and increase in the respective levels. The Mundell-Fleming model thus tells us that a nation effectively surrenders its monetary policy when it chooses to peg its currency to that of another country. The lack of monetary policy control is not a characteristic of a free float exchange regime.

Motivations for Choice of Exchange Rate Regime

Calvo and Mishkin (2003) rightly point out that the reason there exists a wide range of choice of exchange rates, such as currency boards, soft pegs, hard pegs and crawling bands, is because no one universal solution exists for all countries. The authors concede that although no exchange rate regime can prevent macroeconomic turbulence, certain regimes are better suited to the economic characteristics of a country.

To expand on the various reasons a certain exchange rate regime might be adopted, Mankiw (2009), notes their respective advantages, such as:

Table 2: The advantages of fixed and floating exchange rate regimes

Fixed	**Floating**
Monetary policy is committed to the single goal of maintaining peg	Allows monetary policy to be used for other purposes
Exchange rate uncertainty makes international trade more difficult	Leaves monetary policymakers free to pursue other goals such as stabilizing employment or prices
Disciplines MA , prevent excessive money supply growth	
Simpler to implement than other policy rules (inflation rate, nominal GDP targeting)	
Inherit credibility of anchor country	

Source: Author's tabulation from information noted in (Mankiw 2009)

To reiterate the advantages stated in table 2, above all, an advantage of adopting a floating exchange rate system is the freedom which is afforded to the use of monetary policy. Nonetheless, offsetting advantages for using a fixed exchange rate regime include exchange rate certainty and imported credibility of the anchor country.

As a caveat to the advantages noted above in table 2, Calvo and Mishkin (2003) go on to note that although the strongest argument for a floating exchange rate is the ability it affords the relevant institutions to freely use monetary policy to influence domestic conditions, reality has shown often times with emerging markets the monetary authority does not possess the abilities or freedom anyhow to pursue what it deems to be the necessary course. A more relevant consideration, besides the statutory powers of the central bank, it is argued, is the political culture and history of the country. The authors further elaborate by citing Argentina and Canada as examples: legally, the Bank of Canada is not very independent as in the event of an argument between it and the government of Canada; the minister of finance can direct the decision the bank must follow. However, because this has to be clearly motivated in writing and the Bank of Canada carries great public trust, such a move would undermine the government (and, by extension the incumbent ruling party) to its detriment. In contrast, the central bank of Argentina has its independence guaranteed by law and yet in the past the government has simply removed central bank governors who do not act according to the preferred policies of the government.

In his seminal work on optimal currency areas, Mundell (1961) brings another dimension to the fore when he points out that it is better to arrange currencies according to economic regions, provided there exist no barriers to the free flow of factors of production, such as labour. Blanchard (2006) reiterates the argument by stressing the two conditions needed in order for a common currency area to exist, mainly that the countries must experience similar shocks (implying that this would mean some form of alignment or synchronisation in policy) or, barring that, high factor mobility (which acts as a proxy adjustment to shocks). The two conditions effectively exclude the need for exchange rates.

As mentioned by Calvo and Mishkin (2003) above, the choice to adhere to a specific regime is influenced by a myriad of reasons. One such justification is output synchronisation. Others include tight financial or trade sector integration or, to restate Mundell (1961), free factor mobility. Not to be discarded are factors relating to the credibility and capacity of the monetary authority in carrying out monetary policy (Blanchard 2006).

3. Namibia

This section will explore the motivation behind the currency peg arrangement that Namibia has with South Africa. The two countries have an intertwined history, which helps illuminate the reason behind the peg. It thus serves well to investigate the past relationship between the two nations in order to put their current relationship into context.

3.1 Political and Social Background

The 19th century European “Scramble for Africa” resulted in present-day Namibia becoming a colony of Germany. The territory became known as German South West Africa (German SWA) and remained so until the Great War, when Germany was defeated by the allies. Consequently, during the period 1885 – 1918, the dominant foreign group in the territory was the Germans[1] and the dominant economic activities at the time were fishing, farming[2] and mining.

With regards to mining, by 1913, twenty-one percent of the world’s output of diamonds originated from Sperrgebiet in the south of SWA (Dierks 2002, p150) and by 1919 Ernest Oppenheimer of the De Beers diamond group, presently the largest diamond producing company in the world (De Beers Group 2011), had acquired the diamond mines in the vicinity of Luderitz, southern SWA, for the Anglo-American Company and amalgamated them as Consolidated Diamond Mines (Dierks 2002, p173). Copper, gold, tin and salt mining were also dominant mining activities, with railway lines built from the mining-concentrated

[1] Of the 14 380 “whites” who lived in the territory in 1913, 87% were German, 11% Boers (Afrikaners), 1% British and 1% other nationalities (Dierks 2002)
[2] Of the 205 643 cattle in the territory in 1913, 89% were owned by Europeans (Dierks 2002)

areas to the port of Walvis Bay, as well as to South Africa, to facilitate trade. By 1925 mineral exports represented 80 percent of total exports of the country (Dierks 2002, p183).

The Great War broke out in 1914 but at the time Germany was not convinced that her colonies were in peril and the Colonial Ministry sent a telegram in 1914 stating that the "[c]olonies [were] out of danger of war..." (Dierks 2002). War rhetoric aside, by August of 1914 over 4000 fighting men (soldiers and reservists) were mobilised in SWA. The Union of South Africa (a dominion of Britain, 1910 - 1961)[3] did the same, mobilising 60 000 soldiers (Dierks 2002).

By the first week of July 1915 the South African forces had overwhelmed the German forces in SWA and won the war. Martial law was introduced and until 1918 SWA was under South African Military Rule (Dierks 2002).

The Great War ended in 1918 and the German Weimar government was forced by article 119 of the Treaty of Versailles to renounce all her colonies in favour of the Allied Powers. As a result, under Articles 2 and 22 of the Covenant of the League of Nations, SWA was made a Class C Mandate under the Union of South Africa. Boosted by the above, mobility between the two territories increased, both for trade and administrative purposes, and, according to Dierks (2002), by 1921, of the 19 432 "whites" living in SWA, over 10 000 were British subjects.

South Africa's involvement in SWA was absolute (allocation of land, proclamations of laws outlining the legal rights "natives and "whites" had in terms of land ownership, settlements, self-determination, education, religion, labour laws, police force etc) and worrying in its extent that in 1930 the League of Nations resolved that South Africa had no sovereignty

[3] The Union of South Africa became a republic in 1961

rights in the territory (Dierks 2002, p189). In 1933 the Permanent mandates Comission of the League of Nations further objected to the suggestion by South Africa that SWA be incorporated as part of the territory of South Africa (Dierks 2002, p193).

Concurrently, on the global stage, when Britain abondoned the gold standard in 1931, it lead to a decline in the mining industry in South West Africa and by 1931 mining exports represented only 40 percent of total exports of the country (Dierks 2002, p190).

Another event which impacted a great part of the world was the Second World War (WWII). In 1939, when the war broke out, South Africa decided to indirectly support the efforts of Britain. WWII ended in 1945 and in the same year the United Nations was formed (the League of Nations would officially dissolve later in March 1946).

A census was carried out in 1946 and, according to it, the population of South West Africa comprised of 269 569 “blacks” and “coloureds” and 38 020 “whites”. At this stage, even as Britain declared that she would be placing all her mandates under UN trusteeship, South Africa was still taking concrete steps to incorporate South West Africa into its territory (Dierks 2002, p205).

It is from 1946 that prominent “black” inhabitants started petitioning the United Nations against South West African incorporation and making the international community aware of the discriminatory and cruel practices of the South African government against the black population of SWA. The first prominent individual to do so was Chief Hosea Kutako of the Herero.

As part of the efforts by South Africa trying to keep a hold on South West Africa, “whites” from South Africa were being actively encouraged to settle in the latter. By 1949 it was decided by the Prime Minister of South Africa that white inhabitants of SWA would be granted legislative and administrative powers in the South African parliament. Furthermore, the National Party (the white political party which was in power in South Africa at the time) amended the SWA Constitution by deleting references to the mandate (Dierks 2002, p209). The above two action effectively meant a *de facto* incorporation of South West Africa into South Africa. In response, the United Nations General Assembly asked the International Court of Justice to decide the soverignty of South West Africa. On 11 July 1950 the International Court of Justice proclaimed that South Africa had not right to alter the status of South West Africa, a decision which South Africa rejected.

A United Nations Ad Hoc Committee on South West Africa was established in order to settle the dispute over South West Africa. Given the nature of the problem, the meetings were not really productive and by 1951 South Africa had outrightly rejected the legitimacy of the United Nations in this regard. Attempts to have Namibian leaders state their case at the United Nations General Assembly are thwarted by South Africa, which refused to issue passports to the leaders (Dierks 2002, p212). In 1953 the United Nations General Assembly resloved to supervise the mandate of South West Africa, even without the cooperation of South Africa, and in the same year a United Nations Permanent Committee on South West Africa was etablished in terms of UNGA Resolution 749 A (Dierks 2002).

At this juncture a picture which emerges of SWA is a territory which is being governed by South Africa in all but name, against the wishes of the majority (black) inhabitants of the territory, while legal battles are being fought internationally to establish the status of the territory. As with its domestic policy, the National Party of South Africa governed South West Africa according to its apartheid policies. Settlement into South West Africa was encouraged by the South African government and trade between the two territories deepened. The currency of South Africa was used and circulated as legal tender in SWA and monetary policy of SWA was conducted from South Africa.

It should be noted that as time went on, the movement for SWA independence from South Africa gained greater momentum amongst the local non-white population. Resistance to South African rule moved from individuals petitioning the United Nations to organised political parties forming for that very purpose, the largest one being the South West African People's Organisation (SWAPO). The struggle for independence from South Africa by the people and their respective organisations (political and labour) was an ardorous one which, in 1966, culminated in the beginning of an armed struggle by the military wing of SWAPO, the People' s Liberation Army of Namibia (PLAN). The political and armed struggle for indepence from apartheid South Africa is well documented in many historical records and will not be explored in any depth in this text.

To summarise briefly, Dierks (2002) states that by 1975 the Government of the Federal Republic of Germany declared that it recognised the occupation of Namibia by South Africa as illegal and by the late 1970s this was the dominant opinion of countries worldwide. As far back as 1966 the United Nations had declared the rule by mandate of South Africa over South West Africa terminated and South West Africa was seen thenceforth as the direct responsibility of the United Nations, with her right to nationhood and independence confirmed in UNGA Resolution 2145 (Dierks 2002, p239).

In 1978 the United Nations passed out Resolution 435, which outlined the roadmap towards South West African independence (Kotze and Lang 1993). However, independence did not occur for over a decade because of various reasons. One reason is the international context in which the struggle for Namibian independence occurred, namely the Cold War. By the 1980s

SWAPO was receiving military and other assistance from countries such as the then Union of Soviet Socialist Republics (USSR), East Germany and Cuba. The possible spread of socialism and communism onto the African continent was a fear shared by South Africa and the United States of America.

Therefore, one of the reasons little progress was made towards independence was because South Africa insisted that independence of South West Africa could not occur before the Cuban troops, which were providing military assistance to SWAPO, withdrew from Angola. This tactic is known as *linkage* and was supported by the United States of America (Kotze and Lang 1993). According to Kotze and Lang (1993), it was only after several battles between the South African and Cuban troops between 1986 and 1988 that the New York Accord was signed in December 1988, bringing the war to an end.

Namibia held United Nations- supervised elections in November 1989 and on 21 March 1990 the country was formally declared independent.

3.2 Economic Background and Current Ties with South Africa

3.2.1 The Financial Landscape

The historical ties between Namibia and South Africa mean that close economic ties existed and still exist between the two countries, so much so that close to 70 percent of imports into Namibia come from South Africa.

In her book, titled, “Bank of Namibia: Celebrating 20 years in Central Banking”, Brenda Bravenboer (2010), chronicles the history of the usage of various currencies in Namibia. According to the author (Bravenboer 2010), when Namibia was still a colony of Germany, the banking system was naturally modelled on that of Germany. Savings and Cooperative banks were utilised widely. In 1907 the Nord Deutsche Bank of Hamburg, together with the Deutsche-Afrika Bank of Berlin, opened up a branch of Deutsche-Afrika Bank in Luderitz (southern coastal Namibia), which did not advance cash or grant mortgages but dealt exclusively with businesses. Many other banks came into operation during this period, most notably:

- Deutsche Sudwestafrika Genossenschaftsbank (1908)
- Sudwestafrikanishe Bodenkreditgesellschaft (1912)
- Deutsche Kolonial Gessellschaft
- Spar und Darlehnskasse
- Landwirtschaftsbank (1913)

After WWI the only German bank to remain operational was a small mortgage bank, which later became liquidated in 1931. Bravenboer (2010) goes on to state that when the Union of South Africa occupied SWA in 1915 (see previous section), two British South African-based banks started operating in SWA, namely the African Banking Corporation, and Standard Bank. The latter is currently the largest bank on the African continent.

Other banks which came into existence did so mainly via the buying out of the already established German banks. The author goes on to give the National Bank of South Africa as an example, which, in 1915, obtained majority shareholding in the Deutsche-Afrika Bank.

Due to the mining and other economic activities in SWA, Bravenboer (2010) shows that for the period spanning 1918 – 1990, the following banks and building societies operated at some point, or are still operating, in a territory which consisted of less than a million inhabitants:

Banks:-

- Standard Bank
- African Banking Corporation
- National Bank of South Africa (which, in 1925, merged with Anglo-Egyptian Bank and the Colonial Bank to form Barclays Bank. In 1987, due to international sanctions against apartheid South Africa, Barclays International sold its shares off its South African and SWA entities to the Anglo American Corporation and the name of the bank was changed to the current-day First National Bank)
- Bank Windhoek
- Nederlandsche Bank en Credietvergeeniging (the name was changed to Nedbank in 1955)

Building Societies: -

- Allied Building Society
- Johannesburg Building Society
- Natal Building Society
- Permanent Building Society
- Provincial Building Society
- Saambou Building Society
- South African Permanent Building Society
- South African Permanent Mutual Building Society

- Southern trident Building Society
- SWA Building Society (Swabou)
- Trust Building Society
- United Building Society

Most of the above South African building societies eventually ended up closing due to global and local economic reasons (e.g. the stock exchange boom of 1969, competition from commercial banks, heavy government regulation on the way in which building societies were allowed to operate) or transferring their assets to Swabou, which ended up being the only building society at independence in 1990.

Hence, at independence, the Namibian banking sector consisted of five commercial banks, namely: Standard Bank Namibia Ltd, First National Bank of Namibia Ltd, Bank Windhoek Ltd, Commercial Bank of Namibia Ltd and Namibian Banking Corporation.

Commercial Banks are of course under the jurisdiction of a central bank and, for the SWA territory, the commercial banks were supervised by the South African Reserve Bank (SARB), which opened a branch in Windhoek, the capital of SWA/Namibia, in 1961. Bravenboer (2010) notes that although the branch was responsible for the distribution of currency, providing clearing facilities to commercial banks and serving as banker to commercial banks, it did not have the authority to formulate monetary policy as South African policies were made automatically applicable in SWA.

As regards to the currency which was used in SWA, this naturally changed as the territory went from a German colony, to a mandate of the Union of South Africa (“British”), to being under the control of South Africa and, eventually, a sovereign state.

Once again, Bravenboer (2010) notes that earlier trade with gold and silver notwithstanding, the British Pound Sterling ("Pound") was the first currency to be introduced in SWA. The circulation of the Pound goes back to the early 1800s when the Cape Colony of South Africa was occupied by Britain and by 1825 it was recognised as legal tender in South Africa. By 1841 the Pound was the only legal tender in the Cape and by 1850s, when British traders opened a trading depot in the SWA harbour of Walvis Bay; it began to circulate in SWA as well. In addition to this, migrant labour for the mines in South Africa was sourced from parts of SWA, such as the Caprivi, and British colonies, namely: British Bechuanaland (present day Botswana), Northern Rhodesia (present day Zambia), Southern Rhodesia (present day Zimbabwe). The labour sourcing lead to the Pound circulating wider within the territories, as labourers were paid in Pounds.

Although SWA was deemed a German colony from 1885, the German Mark ("Mark") was only introduced as the currency of the territory by proclamation in 1893. Furthermore, the then German Governor of SWA decreed in 1901 that, apart from the Mark, no other currency would be legal tender within German SWA. Despite this, notes Bravenboer (2010), the Pound continued to be used for trade.

As mentioned in the previous section, SWA was defeated by the Union of South Africa in 1915. Thereafter followed a period of uncertainty regarding the currency in which pre-war debts should be repaid. As a way to overcome this confusion, at the end of 1920 a Council of Debt Settlement was instituted and the council decided that pre-war debts should be repaid in gold and other disputes with regard to money matters should be considered according to individual merit.

An important event in the financial landscape was the establishment of the South African Reserve Bank in August 1920 by the Currency and Banking Act in the form of a public company. To this day the equity capital of SARB is held by private individuals and entities and not the government. As mentioned earlier, the SARB established a branch in SWA in 1961.

After 1915 the Pound was once again made legal tender in SWA. The British and South African Pound Sterling continued to be used in South Africa and SWA until May 1961 when South Africa withdrew from the Commonwealth and became a Republic (Bravenboer 2010). The Republic of South Africa (RSA) introduced its own currency, the South African Rand ("Rand"), and the Pound was eventually withdrawn from circulation (Bravenboer 2010). Up to the present day the Rand is still legal tender in Namibia.

As mentioned previously, Namibia was declared an independent nation in 1990. The central bank of the nation, the Bank of Namibia, was established in July 1990 by The Bank of Namibia Act, 1990 (Act No. 8 of 1990), with technical assistance from the IMF, UNDP and the Swedish International Development Cooperation Agency. The way in which the central bank would operate was a topic which was extensively discussed by SWAPO (the internationally recognised representative body of the Namibian people) pre-1990, in preparation for independence and, with the assistance of Olof Palme of Sweden, several options were considered. According to Bravenboer (2010), the following options which were considered:

Autonomous currency board or enclave without a central bank or a currency board system

Namibia would be expected to continue using the Rand as the sole currency and be guided by the Rand Monetary Area (RMA). There would be no central bank and functions normally carried out by a central bank would be carried out by the Ministry of Finance in consultation with the SARB. In effect, the SARB would be the principal monetary authority and the custodian for the management of foreign exchange reserves. There would free movement of capital within the RMA, which would favour SA which has more developed money and capital markets.

A currency enclave or board with limited discretionary monetary authority or central bank

This option is a little more sophisticated than the first, with some influence over the domestic economy. The disadvantages of the first option still remain: exchange rate policy is that of the dominant partner, interest rates must move materially in line with those of the dominant partner, import inflation and every additional unit of currency in circulation must be acquired for value.

A common currency union with a supra-national central bank

A joint central bank and a common currency is shared by a group of countries. To prevent any individual country from influencing monetary and financial policy for its sole interest, the responsibilities of the central bank are jointly managed within a framework of joint-decision making.

An independent monetary or currency system with a fully-fledged central bank

A country would issue its own independent currency backed by its own reserves. With respect to monetary policy matters, the central bank would have a wide range of discretionary powers.

Given the limited experience in monetary policy management, the second option was considered the most favourable for implementation in a newly independent Namibia. The reasoning included the fact that the option would allow the Namibian government to benefit from the experience of South Africa while at the same time providing a narrow scope for discretion. Although it was always going to be the case that Namibia would have its own currency (with the central bank responsible for the issuing of notes and minting of coins, as per Bank of Namibia Act of 1990), the national currency, the Namibia Dollar, was only issued in 1993, after deliberations, research and all specifications by the Technical Committee on the National Currency, which was established in September 1990, were concluded (Bravenboer 2010).

It thus came about that in 1993 an independent Namibia had its own central bank and currency in circulation as well as the Rand.

3.2.2 Current Ties with South Africa

Figure 1: Present day Namibia and South Africa

Source: www.ilike2learn.com/ilike2learn/africa.html

The above map shows the present day borders of Namibia and South Africa. As with most former colonies, the borders were carved and negotiated by the respective former colonial powers. Most countries, including Namibia, agreed to the perimeters at Independence and have not had border disputes with their neighbours.

Namibia is a small open economy which, the CIA Factbook describes, is located in the south-west of the African continent. The territory measures 824 292 square kilometres and is bordered by Angola to its north, South Africa to its south, the Atlantic Ocean to its west, Botswana to its east, and Zambia and Zimbabwe to its north-east. The country has a current population of approximately two million inhabitants and, as a consequence of containing the Namib Desert on its western border and the Kalahari Desert on its eastern border, is mainly arid.

The demographics of the inhabitants of the country reveal a diverse nation, with fifteen different ethnic groups.

Table 3: Macroeconomic indicators of Namibia

Indicator (unit)	**2006**	**2007**	**2008**	**2009**
Population (million)	2	2	2	2
Gini Coefficient	0.6	0.6	0.6	0.6
GDP current prices (N$ million)	54028	62080	74016	78169
GDP constant 2004 prices (N$ million)	46853	49371	51490	51076
% change GDP annual growth	7.1	5.4	4.3	-0.8
GDP per capita (N$)	23,521	24,345	24,935	24,287
GDP per capita (US$)*	3,119	3,228	3,306	3,221
Annual Inflation (%)	5.2	8.3	12.2	9.6
Repo rate	7.7	9.6	10.5	7.7
Broad Money Supply, M2 (N$ million)**	17,796.40	23,244.60	25,908.50	30,004.10
Government budget balance (% GDP)	4.1	5.1	2.0	-1.6
Exports % GDP***	33.2	33.1	35.6	33.8
Imports % GDP***	32.0	35.1	42.3	47.1

Source: Bank of Namibia Quarterly Bulletin December 2010, Bank of Namibia Annual Report 2010

*Using Q2 2010 reported average of N$7.5413/US$

**Currency in circulation + Transferable deposits + Other deposits + Securities included in M2

***Author's computation from data in Bank of Namibia Annual Report 2010

The macroeconomic indicators, as shown in table 3, reveal a country with a vast land mass, small population and a relatively acceptable level of GDP per capita. Nonetheless, the high Gini coefficient[4] reveals an extremely unequal society. The average rate of GDP growth over the noted years has been below 2 percent, with 2009 having had a contraction of 0.8 percent growth. The reason is quite evident: as a small open economy which relies primarily on mining exports, the depressed demand which accompanied the GFC had a negative impact on the economy of the country. The annual rate of inflation averaged 8.4 percent for the period 2006-2009 as a trend points towards increasing imports over the years.

As Namibia and South Africa have a close relationship, it stands to examine how the two countries compare with each other:

Table 4: A comparison of Namibia and South Africa

	South Africa	Namibia
Government	Republic	Republic
Type of State	Secular	Secular
Capital	Pretoria- Executive, Cape Town- Legislative Bloemfontein- Judicial	Windhoek
Population, million	50	2
Area, sq km	1,219,090	824,292
Currency	100 cents = 1 Rand	100 cents = 1 Namibia Dollar
Currency abbreviation/ symbol	ZAR/ R	NAD/ N$
Monetary Authority	South African Reserve Bank	Bank of Namibia
GDP at market prices, million	R 1,858,687 constant 2005 prices	N$/R 51,106 constant 2004 prices

[4] The Gini coefficient is a measure of income inequality within a population. The measure ranges from 0 -1, with 0 indicating complete income equality and 1 indicating complete income inequality

Nominal GDP/capita 2009	U$ 5,823	N$ 37,001 current prices
Rate of Unemployment, %	24* for Q4 2010	51.2 Labour Force Survey 2008
Government balance, % of GDP	-6.2	-7.1 prelim for 2010
CPI 2010 annual average,%	4.3	3.4
Repo rate 2010 annual average, %	6.3	6.9

Source: Bank of Namibia Quarterly Bulletin December 2010, Bank of Namibia Annual Report 2010, SARB, *StatsSA 2011

Politically, both countries are secular republics. Though not too different in landmass size (the area of South Africa is only 1.48 times greater than that of Namibia), the population of South Africa is around 25 times that of Namibia. As the richest nation on the African continent, the GDP of South Africa is over 30 times greater than that of Namibia and, as a reinforcement of the high Gini coefficient of Namibia (table 3), the unemployment rate of South Africa is less than half that of Namibia. Despite the different economic characteristics of the two countries, and because of the fixed exchange rate system between the two countries, the inflation and repo rates of Namibia and South Africa are quite similar, as well as the government deficit levels[5].

3.2.3 Motivations for Pegging

This section will explore the motivations for pegging, explore studied alternatives to the current peg system and later compare the results with those of Hong Kong.

[5] The fiscal similarities are a result of aiming towards uniform good financial management benchmarks set by regional bodies and international ones as well, such as the Bank for International Settlements

The monetary authority of the dominant country has a more sophisticated and deeper developed financial sector and a more robust monetary framework

The non-banking financial sector of South Africa is regulated by the Financial Services Board (FSB), while that of Namibia is regulated by the Namibia Financial Institutions Supervisory Authority (NAMFISA). Both of the sectors are dynamic, as is evidenced by the following statistics:

Table 5: A list of non-banking financial institutions in South Africa

South Africa		
Type		**Number**
Registered Retirement Funds		10 699
Long-term Insurers		88
Short-term Insurers		110
Friendly Societies		198
Local Collective Investment Schemes	Schemes in Securities	990
	Schemes in Property	12
	Schemes in Participation bonds	5
Foreign Collective Investment Schemes		433

Source: FSB Annual Report 2010. All figures as at 31 March 2010, except Friendly Societies, which is as at December 2008

Table 6: A list of non-banking financial institutions in Namibia

Namibia	
Type	**Number**
Friendly Societies	3
Long-term Insurers	18
Short-term Insurers	13
Reinsurers	2
Medical Aid Funds	9
Pension Funds	169
Stock Exchanges	1

Source: NAMFISA Annual Report 2010

Though not extensively mentioned in the FSB Annual Report 2010, the Johannesburg Stock Exchange (JSX) is the largest on the African continent and the 16th largest in the world, with over 400 listed companies, while the Namibian Stock Exchange (NSX) has a combined number of 34 listed companies. The volumes trades on the JSX are naturally far greater than those traded on the NSX, with market capitalisation being over R6 trillion and under R10 million for the JSX and NSX respectively, for the weekly period ending 25 March (JSX 2011), (NSX 2011).

While the numbers in table 5 and table 6 are not meant to conclusively show that the financial sector of South Africa is more sophisticated than that of Namibia, it is reasonable to conclude that, because the financial system of South Africa is older and far larger than that of Namibia, it is more sophisticated.

It has been previously stated that the banking financial sector of Namibia is regulated by the Bank of Namibia, while that of South Africa is overseen by the South African Reserve Bank. The Bank of Namibia reports that there are five authorised commercial banks presently operating in Namibia, of which four are subsidiaries of South African banks and one is a Namibian wholly-owned company (Bank of Namibia, Banking Supervision and Regulation 2011). Similarly, the South African Reserve Bank notes that there is currently a cumulative 65 registered banks and representative offices operating in the country (SARB, South African Registered Banks and Representative Offices 2011)[6].

With regard to the framework within which the central banks operate, the Monetary Policy Framework of the Bank of Namibia explicitly outlines the sustention of the linked-currency arrangement as its intermediate target as this will ensure price stability through the anchor to the Rand. The bank freely acknowledges its loss of monetary policy discretion in this regard (Bank of Namibia Monetary Policy Framework 2011).

[6] Includes locally controlled registered banks, foreign controlled registered banks, registered branches and foreign bank representative offices

As for the South African Reserve Bank, the Bank operates within a monetary policy framework of a 3 – 6 percent inflation rate target. This policy is pursued with the goals of financial stabilty and economic growth in mind. Namibia benefits from the stability afforded by the inflation targeting regime of 3 - 6 percent of South Africa. This target helps to anchor interest rate and inflation rate expectations.

To conclude, South Africa is the dominant financial partner of the two nations with more banking and non-banking financial institutions. This implies greater levels of sophistication in these markets when compared to those of their Namibian counterparts. As a result, Namibia has assented to allow its monetary policy to be dictated by that of South Africa for the intermediate term.

The freedom of the monetary authority is hampered in a manner which lends doubt to the credibility of the monetary authority

One of the reasons put forth when advocating for a linked exchange rate regime is the lack of credibility of the monetary authority of the home country. Below this study will investigate the credibility of the Bank of Namibia by examining the legal framework within which the bank was established and operates, its internal control processes and staff composition, and its level of transparency.

1. ***Legal framework***

The foundation of the Bank of Namibia is enshrined in Article 128(1) of the Constitution of Namibia which states that "[t]here shall be established by Act of Parliament a Central Bank of the Republic of Namibia which shall serves as the State's principal instrument to control money supply, the currency and the institutions of finance and to perform all other functions ordinarily performed by a central bank" (Bravenboer 2010, p33).

The central bank goes on to note that objectives of the Bank of Namibia are outlined in The Bank of Namibia Act 15 of 1997, which states that the objects of the bank shall be-

(*a*) to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of that system;

(*b*) to promote and maintain internal and external monetary stability and an efficient payments mechanism;

(*c*) to foster monetary, credit and financial conditions conducive to the orderly, balanced and sustained economic development of Namibia;

(*d*) to serve as the Government's banker, financial advisor and fiscal agent; and

(*e*) to assist in the attainment of national economic goals.

(Bank of Namibia Act 2011)

The Bank is therefore an instrument of the government with its objectives decided by an act of parliament. The line ministry of the bank is the Ministry of Finance. Regardless of this, there exists operational freedom and Act 15 of 1997 goes on to stipulate that, in the event that the Minister of Finance does not agree with a decision taken by the Bank of Namibia, he or she will have to "submit a recommendation to the Cabinet, and the Cabinet may, after consultation with the Board, determine the policy to be adopted by the Bank, and issue a directive setting out the essential policy reasons therefore and specifying the period during which such policy shall be implemented by the Bank" (Bank of Namibia Act 2011, PART VII).

What is emerges from the above is the fact that if the Minister wishes to change a decision taken by the Bank of Namibia, he or she would have to motivate the reasons to Cabinet, who shall make a final decision pending consultation with the Board of Directors of the Bank of Namibia and by explaining the reasons for the decision.

To prevent influence from the financial sector on the Bank of Namibia, the Act goes on to prohibit the Bank of Namibia from “engag[ing] in trade, purchase, or otherwise acquire shares in any banking institution or any corporation or company, or otherwise have ownership interest in any financial, commercial, agricultural, industrial, or other business undertaking” (Bank of Namibia Act 2011, PART IX).

2. *Internal control processes and staff composition*

To minimise operational risk, the Risk Management and Assurance Office of the bank has to “[p]lan, co-ordinate and monitor the adequacy and effectiveness of the risk management process on a bank-wide level by identifying, assessing and evaluating significant risk exposures to the Bank and contribute to the improvement of risk management and internal control systems... The office also has to Review departments within the Bank at appropriate intervals to determine whether they are economically, efficiently and effectively carrying out their functions in accordance with management, instructions, policies, and procedures, and in the manner that is consistent with the Bank's strategic objectives” (Bank of Namibia, Internal Audit Division, 2011). The outcomes of these inspections are reported to the Auditing Committee of the bank of Namibia.

Another aspect of risk comes from the staff composition of the organisation. According to its Annual Report (2010) as at 31 December 2010, the Bank of Namibia employed 306 staff members with the qualifications of PhD (2 pending), Masters (37), Bachelor or Honours (75), Diploma (66) and Grade 12 or below (128).

The above includes both core and support services department. The employees working in the departments of Research, Banking Supervision, Financial Markets, Information Technology and the Financial Intelligence Centre specifically are held to a high standard of educational qualification, given the important and wide-reaching mandate of the bank.

3. *Transparency*

As part of its communication strategy the Bank of Namibia aims to inform and educate the public on its functions and decision making processes. To that end it publishes the minutes of the Monetary Policy Committee[7] on its website as well as the following publications: the Quarterly Bulletin, the Monetary Policy Review (included in the Quarterly Bulletin), the Financial Stability Review (every 6 months), the Annual Report and various working papers. Other outreach efforts to the community include the Governor's Annual Address (a dinner with the business community), the Annual Symposium and newspaper articles. Media communication via a press conference and press releases regarding the decisions of the Monetary Committee occurs a day after the rate decision is made.

To conclude, the foundation of the Bank of Namibia is enshrined in the constitution of the country. This makes the existence of the central bank intransient, regardless of the government of the country. While the bank is an instrument of government, it enjoys operational freedom, with the law requiring that any interference by its line ministry has to go via Cabinet and has to be properly motivated.

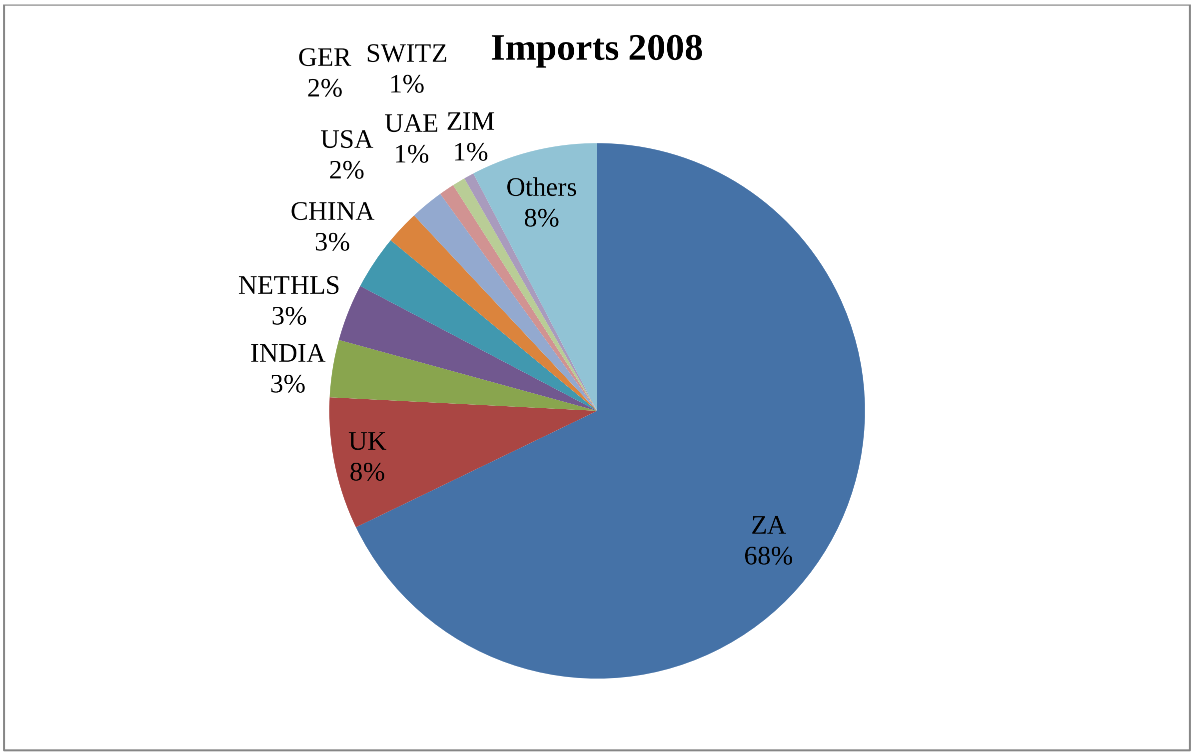
[7] The Monetary Policy Committee makes the decision on the repo rate

The bank has competent staff and a very clear communication strategy which aims at continuously increasing the transparency (and by proxy, the trust) of the central bank in the eyes of the public.

The majority of external and financial transactions in Namibia are conducted in the South African currency

The figures and table below indicate that South Africa is the single largest trading partner of Namibia and has consistently been so over the years:

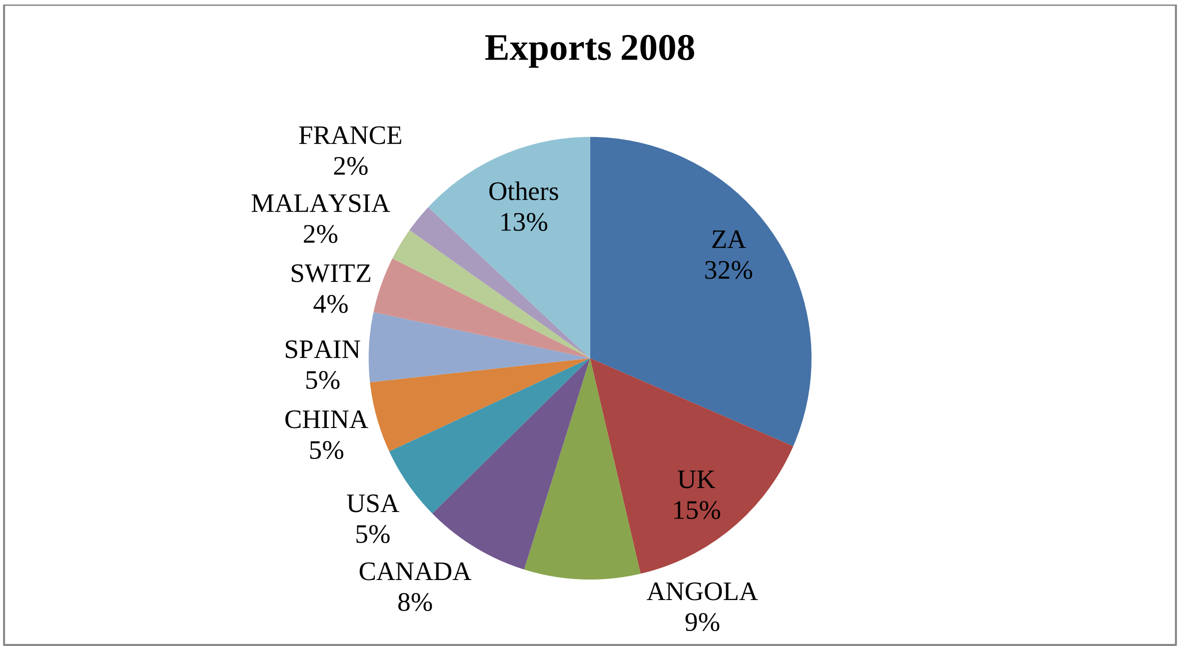
Figure 2: Import data for Namibia 2008



Source: Author's computation from data obtained from National Planning Commission, Central Bureau of Statistics (CBS), Trade Statistics

As is indicated in Figure 2, the bulk of imports into Namibia in 2008 came via South Africa. The second largest import component came from the United Kingdom, with the rest of the world contributing less than a quarter to the import account of Namibia.

Figure 3: Export data for Namibia 2008

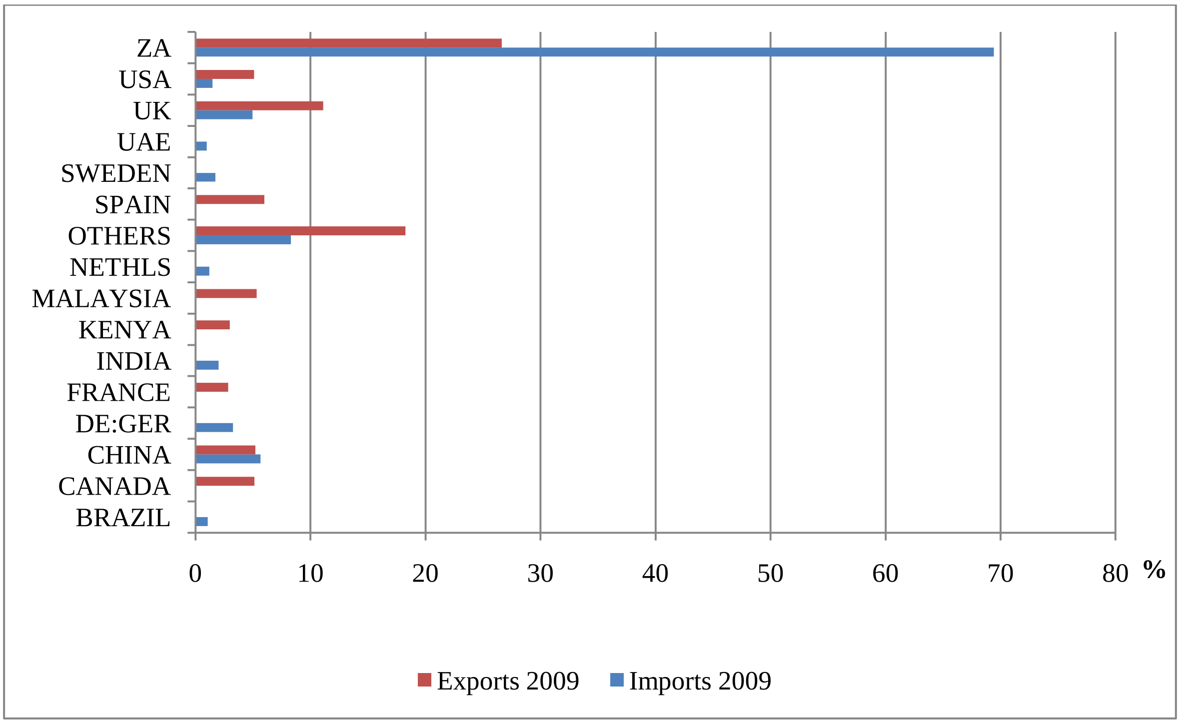


Source: Author's computation from data obtained from National Planning commission, Central Bureau of Statistics, Trade Statistics

As with the case of imports, Figure 3 clearly states that the single largest country to which Namibia exported to in 2008 was South Africa. Exports to South Africa amounted to nearly a third of all exports from Namibia in 2008. The second largest destination country/region was the United Kingdom, with 15 percent, followed by Namibia's northern neighbour, Angola, with 9 percent.

The data in Figure 2 and Figure 3 show that in 2008, South Africa was the single largest trading partner of Namibia in terms of import and export traffic, a trend which had not changed in 2009, as Figure 4 indicates below. As in 2008, nearly 70 percent of imports into Namibia came from South Africa, although less than 30 percent of exports went to South Africa. The second largest single country import partner for in 2009 was China, at just above 5 percent, which was followed by the United Kingdom.

Figure 4: Trade data for Namibia



Source: Author's computation from data obtained from National Planning commission, Central Bureau of Statistics, Trade Statistics

Table 7: Top export destinations for Namibia

	Top 10 Export Destinations					
	2004	**2005**	**2006**	**2007**	**2008**	**2009**
1	South Africa	South Africa	UK	South Africa	South Africa	South Africa
2	UK	UK	South Africa	UK	UK	Angola
3	France	USA	Italy	Italy	Angola	UK
4	Angola	Spain	Spain	Angola	Canada	Spain
5	USA	Angola	Angola	Spain	USA	Malaysia
6	Spain	Germany	Canada	Canada	China	China
7	United States Minor O/lying Islands	Canada	Germany	China	Spain	Canada
8	Canada	Italy	USA	USA	Switzerland	USA
9	Italy	China	Taiwan	Germany	Malaysia	Kenya
10	Germany	Israel	Korea	France	France	France

Source: National Planning Commission, Central Bureau of Statistics, Trade Statistics

To give a broader view of the trade patterns of Namibia, table 7 shows that over a period of six years spanning 2004 -2009, South Africa has been the dominating export partner of Namibia.

The importing and exporting of goods between Namibia and South Africa is conducted in Rands. This is because the currency is legal tender in both countries. Because there is no need to change currency between the two territories, transaction costs of doing business are lowered. According to the Bank of Namibia (2003), over half of the trade of Namibia is conducted in Rands.

There exists output synchronisation between the two territories

Although the two countries share close ties, output synchronisation, as proxied by the gross domestic product, is not very strong between the two nations. A simple regression run on the gross domestic products of the two countries, below, reveals an R^2 = 0.039

Figure 5: Results of Regression Analysis

Regression Analysis

r^2	0.039	n	29
r	0.197	k	1
Std. Error	3.122	Dep. Var.	**Y**

ANOVA table

Source	*SS*	*df*	*MS*	*F*	*p-value*
Regression	10.5969	1	10.5969	1.09	.3063
Residual	263.1395	27	9.7459		
Total	273.7364	28			

Regression output

					confidence interval	
variables	*coefficients*	*std. error*	*t (df=27)*	*p-value*	*95% lower*	*95% upper*
Intercept	2.7527	0.7957	3.460	.0018	1.1201	4.3853
X1	0.2498	0.2395	1.043	.3063	-0.2417	0.7412

Source: Author's computation from data obtained from World Bank WDI database

To put the result in figure 5 above in context R^2 is a measure which shows how much the change in one variable (in this case, the GDP of Namibia) is caused by a change in the second variable (in this case the GDP of South Africa). The R^2 ranges between the values of 0 and 1.

R^2 = 0 implies no influence

R^2 = 1 implies complete influence

Thus, what the result R^2 = 0.039 indicates is that less than 4 percent of the change in the GDP of Namibia is influenced by the change in the GDP of South Africa, which is very little influence indeed. Additionally, the last line in figure 5 associates the independent variable X1 (GDP of South Africa) with a p-value of 0.3063. Essentially what the p-value indicates is that at a 5 percent significance level, the relationship between the GDP of Namibia and the GDP of South Africa is not “significant enough” to not attribute it to chance. This reinforces the conclusion deduced from the R^2 figure.

An explanation for the seemingly contradictory results above is the fact that the great majority of trade for Namibia is still comprised of mining exports, of which the majority is not destined for South Africa. According to the National Accounts, as quoted in the Bank of Namibia Annual Report 2010, the *mining and quarrying* category has consistently been the second single largest contributor to GDP, with the component singly contributing an average of 12.3 percent for the period 2006-2009. Additionally, the *manufacturing* category, which is the single largest contributor to GDP, contributed an average of 14.1 percent for the period 2006- 2009. The category consists of meat and fish processing, which is exported to the European and other African markets.

Taking the above into account, a weakly synchronised output does not undermine the great volume of trade and depth of financial ties between the two countries as there can be many reasons to explain the weak correlation.

There exists free factor mobility between the two countries as well as close trade and financial relationships

The trade and financial relationships between the two countries have already been covered and shown to be close, mainly as a result of the intertwined history and geographical proximity of the two countries.

As shown below in table 8, Namibia and South Africa are both members of the CMA, SACU and SADC. The implications are that barriers to entry between the two nations are reduced when it comes to the free flow of labour and other factors of production.

There exist pertinent political reasons for the peg

Namibia and South Africa are members of several trade and political regional bodies. The two countries are members to the Common Monetary Area (CMA), the Southern African Customs Union (SACU), the Southern African Development Community (SADC) and the African Union (AU).

Table 8: Regional bodies

CMA	**SACU**	**SADC**	**AU**
Namibia	Namibia	Namibia	All African
South Africa	South Africa	South Africa	States
Lesotho	Lesotho	Lesotho	excl.
Swaziland	Swaziland	Swaziland	Morocco
	Botswana	Botswana	
		Angola	
		D.R.C	
		Madagascar	
		Malawi	
		Mauritius	
		Mozambique	
		Seychelles	
		Tanzania	
		Zambia	
		Zimbabwe	

Source: websites of the above organisations

The CMA block consists of countries where the Rand is legal tender. The arrangement has meant a close monetary and fiscal relationship between the member countries. According to the IMF Working Paper authored by Wang et al (2007, p34), data spanning two decades has revealed the following benfits for the member countries: cross-border trade and capitla flows facilitation, a framework for monetary policy, price stability and positive spillover effects as a result of the link to the credible SARB.

A caution about this arrangement lies in the fact that although most of the imports into Namibia originate from South Africa, the same is not as strong for exports out of Namibia. If the Rand were to appreciate, this could affect the competitiveness of goods exported out of Namibia.

Nonetheless, the current sentiments in the political sphere are those of closer cooperation and integration between countries. The question of whether the CMA arrangement has overall been beneficial to Namibia is beyond the scope of this paper but is well investigated by Wang et al (2007), amongst others. As it stands, no pronouncemnts have been made by the monetary or political authorities in support of a breakaway from the CMA arrangement.

SACU is the world's oldest customs union, founded in 1910, and is comprised of the CMA countries plus Botswana. To summaries, no trade tariffs apply between the member states and collected tariffs at their respective borders/points of entry are distributed amongst the member countries according to a predetermined formula. According to the SACU website, there exist legal frameworks in place which aim to deepen integration between the member countries in various sectors by formulating common policies in the areas of industry, competition, trade and negotiations with third parties. Namibia's 101 year continued membership in the Union is an indication of political support of SACU.

On a larger scale, Namibia's membership to SADC is very important, particularly since the member countries have pledged to cooperate in non-financial matters such as defense, politics and security (SADC 2010). An impotant objective of the body, in line with greater cooperation and integration, is the establishment of a Monetary Union by 2016 and a Single Currency by 2018 (SADC 2010).

To conclude, Namibia and South Africa are members of common regional bodies and the stated aim of these bodies is greater cooperation and integration, with SADC aspiring towards a common currency area. The four CMA members thus form the "nucleus" of this aspiration and it is assumed that lessons learned from the CMA arrangement as well as other common currency areas, like the Euro Area, will be taken into account when designing the envisioned SADC Monetary Union.

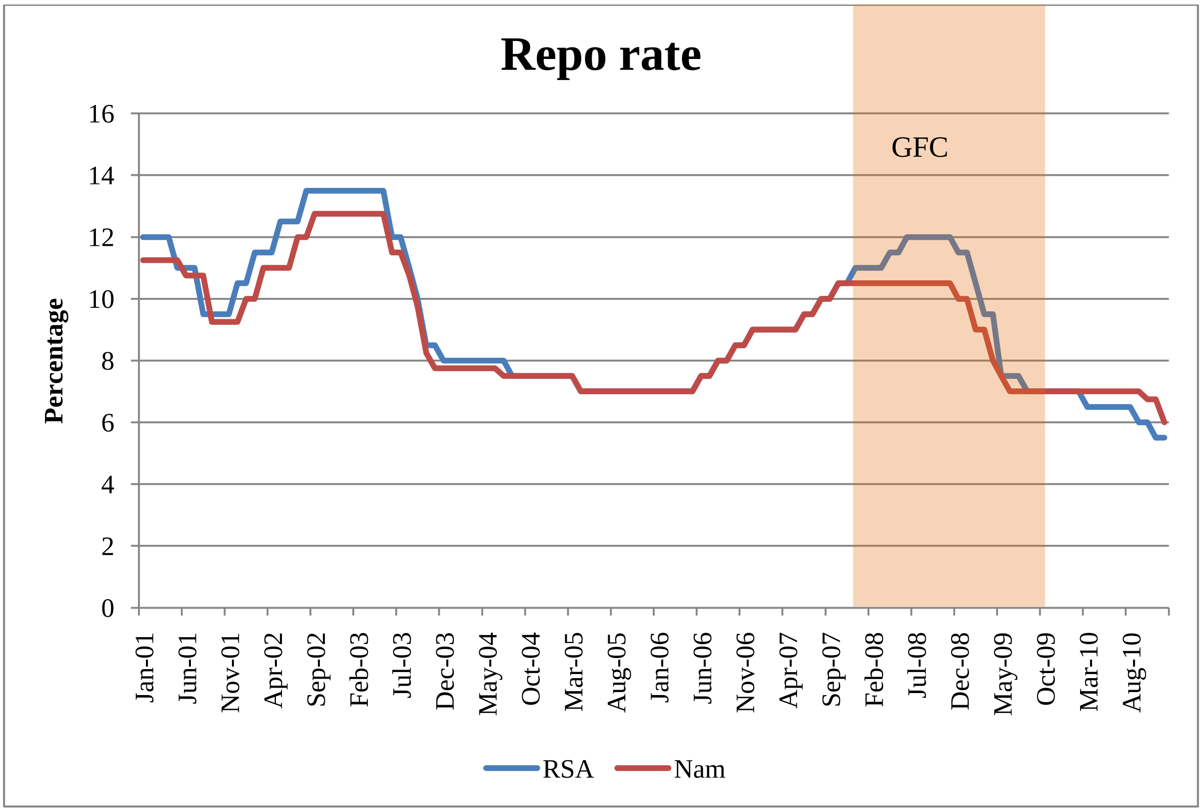
The momentum of relations thus appears to be headed towards greater integration. As a result, it is unlikely that Namibia would break its already established and old monetary relationship with South Africa, and certainly not without great political contemplation.

Whether the stated political aims will be to the benefit of all countries is to be seen, although history reveals that such an arrangement is usually to the detriment of some members (Blanchard 2006, p434). The study of the topic is however not in the scope of this paper.

The current system has not hindered the economic growth of Namibia

It is true that because of the fixed-exchange rate arrangement, Namibia has surrendered its monetary policy to South Africa. As a result, the repo rates of the two countries have all but been identical, with Namibia taking its cues from South Africa.

Figure 6: Repo rate of Namibia and South Africa



Source: Bank of Namibia Quarterly Bulletin December 2010 and other Bank of Namibia publications

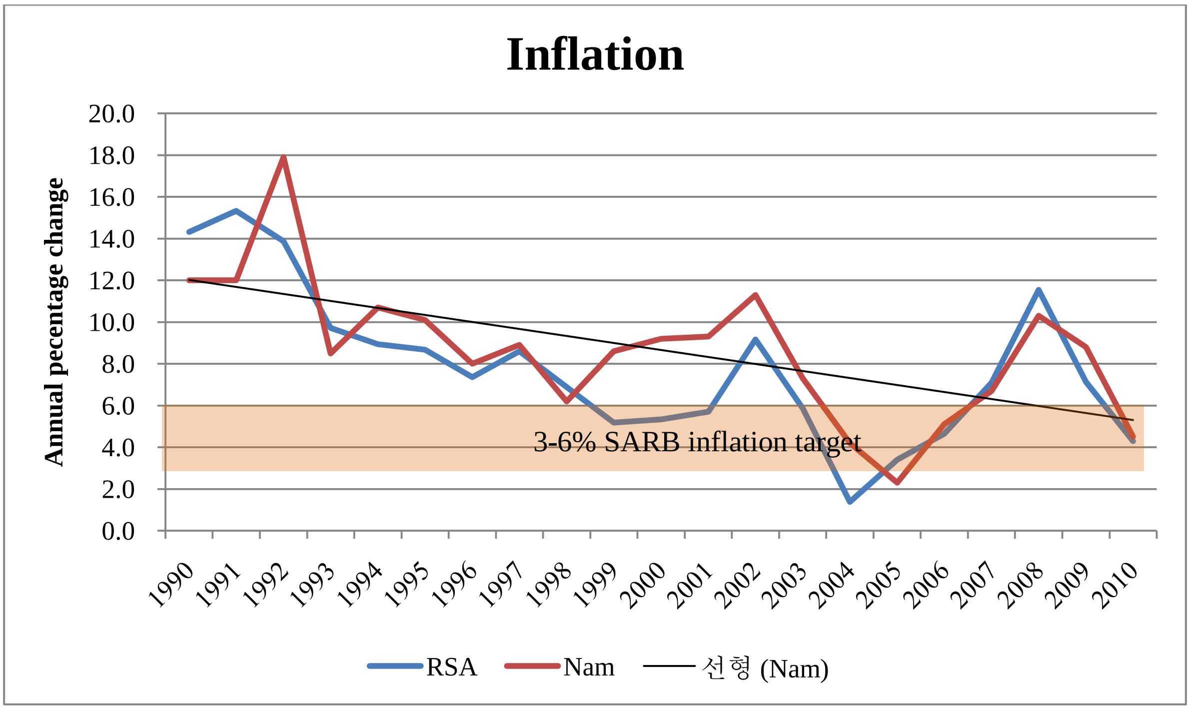
As a result of the arrangement, the inflation rates of the two countries have also been moving in tandem, as Namibia imports a significant amount of inflation from South Africa. As is shown in Figure 6, for the period January 2001 – May 2003 the repo rate decisions of the Bank of Namibia lagged slightly behind those of the SARB and the announced repo rate by the BoN tended to be higher. The slightly higher repo rate could be because a premium had to be added by BoN to take imported inflation from South Africa into account. In fact, Figure 7 below shows that for the noted period the inflation rate of Namibia was always higher than that of South Africa. For a period of three years, from September 2004 – October 2007, the bank rates between the two countries were identical, which is a typical situation between two nations with a fixed exchange rate. Atypical was the Global Financial Crisis, which began approximately in the last quarter of 2007. As is shown by the comparison of the repo rates above, the Bank of Namibia employed a much more expansionary monetary policy than the SARB during the GFC. This is because Namibia, which is a small open economy dependent on exports from its primary industry, most notably mining, suffered to a great extent when demand for, and the prices of, minerals such as copper and diamonds[8] declined during the GFC. Thousands of workers in the diamond and copper sector were made redundant and copper mines had to shut down.

What the above illustrates is the fact that the structures of the two economies are obviously different, which has meant different levels of exposure to various external shocks to the two economies. This is a recognised disadvantage to a fixed rate. The stress to the peg as a result of the divergent repo rates has not been officially reported.

[8] At the time of the GFC, the Namibian Diamond Corporation, Namdeb, was the single largest employer in Namibia, after the government, and it had to lay off employees in 2008 and 2009.

The Bank of Namibia, in its Monetary Policy Framework (2011), explains that it has a small window for discretionary monetary policy through the employment of capital controls and prudential requirements to control the domestic money supply. The Bank contends that this allows it to control for domestically induced inflation. The Bank, quoting a study done by Mihe Gaomab II in 1998[9], contends that this figure stands at 35 percent. Therefore, although the overall trends in inflation have been similar between the two countries (Figure 7), the specific figures have not been identical.

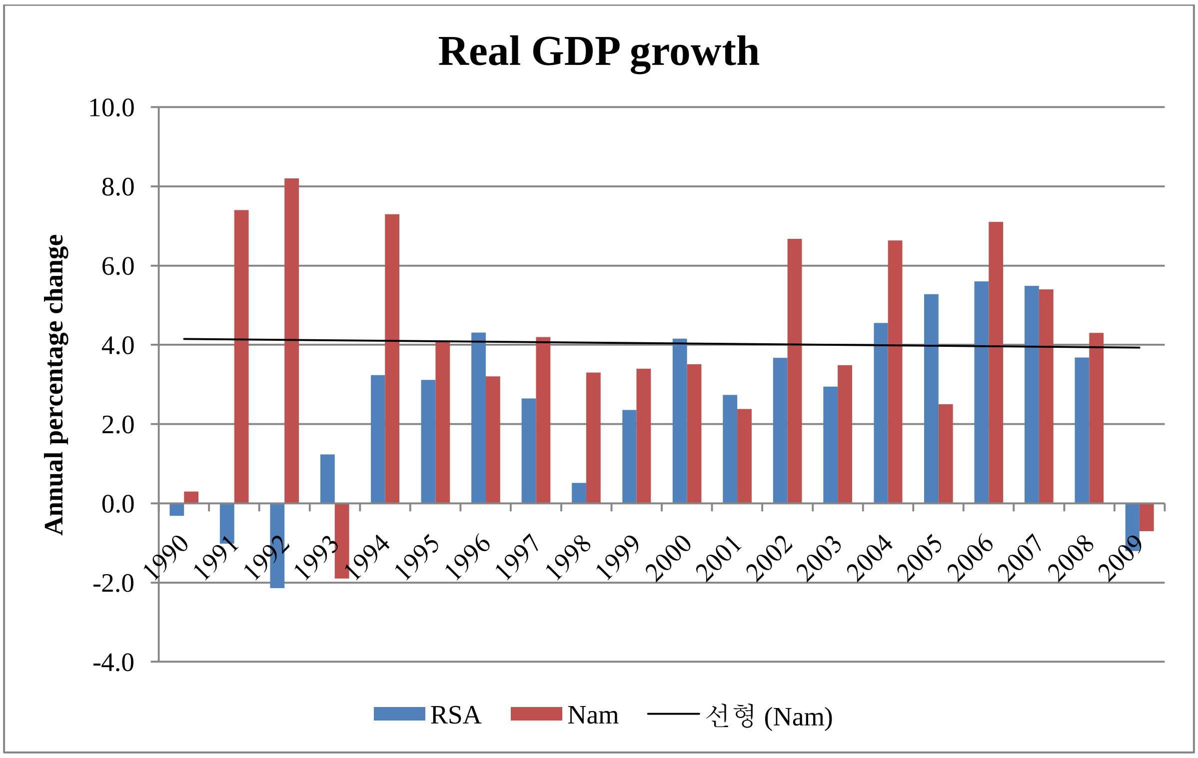
Figure 7: Inflation rate of Namibia and South Africa



Source: Bank of Namibia Annual Report 2010, StatsSA 2011, World Bank WDI database

[9] Title: Modeling inflation in Namibia

Figure 8: Real GDP growth of Namibia and South Africa



Source: World Bank WDI database, SARB 2011, Bank of Namibia Quarterly Bulletin December 2010

The economy of Namibia has never had a period when it did not have strong linkages to that of South Africa. A "before and after" comparison of GDP growth is thus not possible. What is instructive to see in Figure 8 is that only during the period 1990-1993 did the two countries have opposite GDP growth directions. This could be explained that the period was one of social and political turmoil for both countries, with Namibia gaining independence in 1990 and South Africa holding its first free elections in 1994. Thus it was a period of uncertainty, which affected the economies of both countries respectively.

Figure 8 shows that from 1994 the GDP growth trends have been in the same direction for Namibia and South Africa, specific magnitudes notwithstanding. Of those 16 years noted above, 11 consisted of the GDP growth of Namibia being higher than that of South Africa. Whether the economic growth of Namibia has suffered as a result of the fixed rate exchange regime is hard to ascertain but what the data above does show is that the GDP growth of Namibia has, for the most part, fared better than that of South Africa.

3.2.4 Exploring Alternative Currency Regimes

The Bank of Namibia has explored possible alternative exchange rates for the country, should it no longer be feasible to support the peg in its current form. According to the Bank of Namibia (2003), the following alternatives could be considered:

A basket of currencies comprising of the Rand and SDR

The Bank established that the Rand constitues close to 60 percent of the total transactions between Namibia and the rest of the world. In order to represent other currencies as accurately as possible, the Bank felt that using the SDR as a proxy for The Rest of the World would suffice. The benefit of this arrangement would not only be a reduced influence of Rand volatility for Namibia but also, by including the SDR, the inclusion of Namibia’s other major trading partners, whose currencies happen to prominently make up the SDR basket (the USD, Euro and GBP).

A basket of currencies based strictly on trade weights

The difference between this option and the first one would be the composition and design of the basket. Trade statistics for export and import values would be instrumental in this design. As with the above alternative, the advantage of the option would be reduced reliance on a single currency and thus less felt impact from the volatility of a single currency. Nonetheless, the construction of such a basket would need great technical skill. Such an arrangement is also prone to less transperancy as it would be constructed to the discretion of the central bank. Additionally, as trading patterns and pertners change with time and circumstance, the constant revision of the composition of the basket could lead to investor uncertainty and speculation in the financial and import and export sectors of the economy.

A single peg

Namibia would have to find an alternative currency to which to peg the Dollar. Trade data confirms that South Africa is Namibia's largest trading partner. Peg to another currency is not a realistic alternative.

4. A Comparison of the Case of Hong Kong with that of Namibia

4.1 A History and Study of the Exchange Rate Regime of Hong Kong

One of the most well-known instances of a territory pegging its currency to that of another is the Hong Kong- United States relationship. Both territories are dominant global economic players and thus do not fit the mould of an under-developed territory pegging its currency to that of a developed territory.

There must thus be specific reasons as to why Hong Kong has decided to follow this particular route. Those reasons shall be explored in this section and a contrast of these reasons shall be made against those of the Namibia- South Africa case later in the study.

Hong Kong, though a territory of China, is classified as a Special Administrative Region (SAR). As a result of this designation, Hong Kong has a degree of autonomy when it comes to certain domestic issues, including the issuing and controlling of its own currency. This arrangement, notes the CIA (2011), is expected to last until 2047.

It has been noted that one of the reasons countries have a peg or closely synchronized currency agreements is due to geographical proximity. The Hong Kong Dollar is pegged to the United States Dollar, although the United States of America is neither a former colonial master nor neighbour of China (the distance between Hong Kong and Washington DC is over 8000 miles). Since the reasons for the peg are not political, as could be argued about the European Union common currency area, they must be economic.

Monetary policy in Hong Kong is conducted by the Hong Kong Monetary Authority (HKMA) and, according to its website, (HKMA 2011), it was established on 1 April 1993 by merging the Office of the Exchange Fund with the Office of the Commissioner of Banking. Its main objectives and functions are:

- maintaining currency stability within the framework of the Linked Exchange Rate system

- promoting the stability and integrity of the financial system, including the banking system
- helping to maintain Hong Kong's status as an international financial centre, including the maintenance and development of Hong Kong's financial infrastructure

As is thus evident, the reason for the pegged regime with the USD is to provide stability for its financial sector and guard the reputation of Hong Kong as an international financial sector.

Since 1983 the Hong Kong dollar has been linked to the US dollar at the rate of HK$7.8 to one US dollar. What is instructive is to explore the motivations behind the peg and how the HKMA came to peg the Hong Kong Dollar (HK$) to the United States Dollar (US$). For the most part of its history Hong Kong has had a fixed currency regime in one form or another, as is shown in table 9. According to the HKMA Background Brief (2005) the following currency regimes have all been used in the past by the territory:

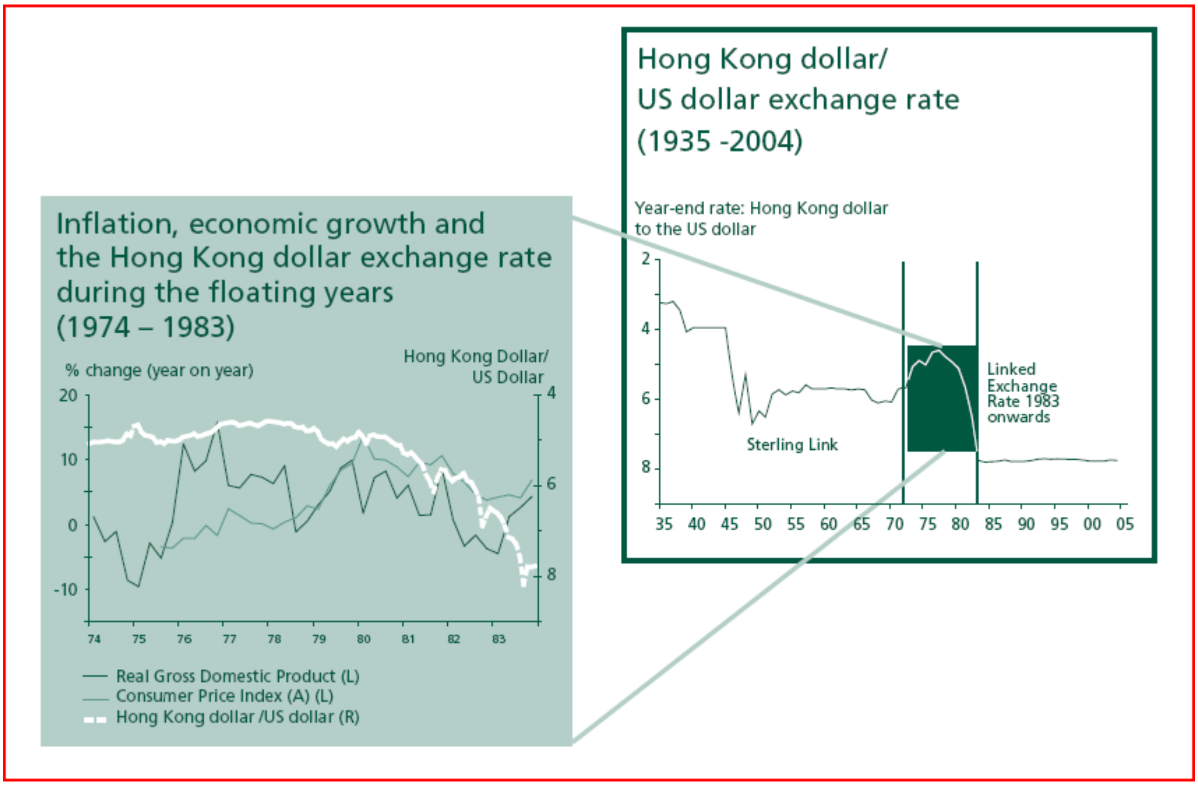
Table 9: Hong Kong exchange rate regimes

<table>
<tr><th colspan="3">Exchange Rate Regimes for the Hong Kong Dollar</th></tr>
<tr><th>Date</th><th>Exchange Rate Regime</th><th>Reference Rate</th></tr>
<tr><td>1863- 4Nov 1935</td><td>Silver</td><td>Silver dollar legal tender</td></tr>
<tr><td rowspan="2">Dec 1935</td><td>Link to Sterling</td><td>£1 = HK$16
Dec 1935 – Nov 1967</td></tr>
<tr><td>Link to Sterling</td><td>£1 = HK$14.55
Nov 1967 – June 1972</td></tr>
<tr><td rowspan="2">6 July 1972</td><td>Link to USD with ±2.25% Intervention bands around central rate</td><td>US$1 = HK$ 5.65
July 1972 – Feb 1973</td></tr>
<tr><td>Link to USD</td><td>US$ 1 = HK$ 5.085
14 Feb 1973- Nov 1974</td></tr>
<tr><td>25 Nov 1974</td><td>Free Float</td><td>Exchange rate at selected dates:
US$ 1 = HK$ 4.965
(25 Nov 1974)
US$1 = HK$9.600
(24 Sept 1983)</td></tr>
<tr><td>17 October 1983</td><td>Link to USD</td><td>US$1 = HK$ 7.80</td></tr>
</table>

Source: Reproduced from (Background Brief, HKMA, 2005, pg 7)

As can be seen in table 9, there was a brief time when Hong Kong employed a free float system, from 1974 to 1983. The reason that Hong Kong reverted back to a fixed system is because it was felt that the *monetary policy framework was not sophisticated* enough to replace the external anchor. Another reason for the move in 1983 was to *bring stability to a volatile banking sector* (see figure 9 below) and, with it, confidence in the system.

Figure 9: Volatility of the HK$ 1974-1983



Source: Reproduced from (Background Brief, HKMA, 2005, pg 8)

Figure 9 above shows that there was volatility in inflation, economic growth and the currency during the years in which Hong Kong employed a free float exchange rate system.

Nearly three decades since the adoption of the peg global economic conditions have changed many times over but the HKMA still continues to operate under the fixed peg system adopted in the early 1980s.The reasons the HKMA gives for the continued use of the system include:

- the system is simple, consistent and well understood

- the system allows for adjustment to shocks without the damage and volatility of a sudden currency collapse
- firm anchor reduces foreign exchange risk to importers, exporters and investors
- the USD is the predominant foreign currency in which external trade and financial transactions are conducted
- the strong and solvent banking system of Hong Kong means that it is well able to cope with fluctuations in interest rates which may rise under a fixed peg system
- there exists ample foreign currency to support the peg. As of end September 2005, Hong Kong had US$122.8billion in foreign reserves, which amounted to over six times currency in circulation.

The next logical step is to examine the limitations which come with the choice of such a regime for Hong Kong. In its Background Brief, the HKMA (2005) identifies the following limitations to a fixed exchange rate system:

- unable to use nominal exchange rate movements as a mechanism for adjustment
- the peg ties Hong Kong to US monetary policy even in instances when the economic cycles of the two territories may not necessarily be moving in tandem
- there exists little scope for an autonomous interest rate policy to achieve price stability or promote economic growth.

As with the case of the Bank of Namibia, the HKMA explored alternatives to the current peg system. The following alternatives were investigated by the HKMA:

A once-off change in the exchange rate

This is meant to shift economic adjustment pressures to the nominal exchange rate and thus alleviate the pain from nominal price and wage adjustments as would otherwise be required. The problem with this move is that any change in the nominal exchange rate undermines the credibility of the monetary authority. The move would also invite speculation on future changes and undermine investor confidence.

A link to another currency

It makes sense to link to the currency most used in external trade and financial transactions. Furthermore, one must be confident in the credibility of the monetary authority governing that currency. The HKMA feels that the US Dollar and Federal Reserve Bank answer to both criteria.

A link to a basket of currencies

This arrangement would mean that the economy would be less exposed to sharp swings in the exchange and interest rates of a single anchor currency. However, the system increases the complexity of undertaking monetary stability while at the same time reduces the perceived transparency of the monetary authority. Because the monetary authority retains the discretion in deciding and adjusting the weights of the various component currencies, predictability and transparency are reduced, which in turn reduces public confidence in the monetary authority.

Adopting a free float system

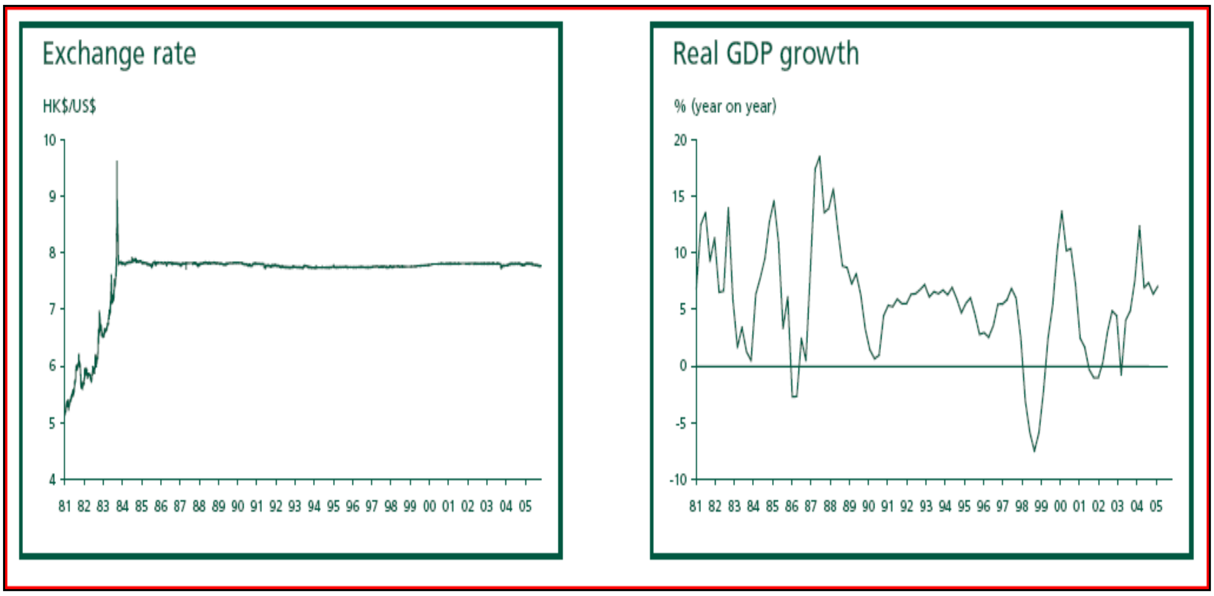
This system would allow the monetary authorities to pursue autonomous monetary policy in line with price stability and economic growth objectives. The HKMA authority feels that because Hong Kong is a highly externally orientated economy, the free float system would leave Hong Kong vulnerable to the volatility of international capital flows. It also feels that an increase in exchange rate fluctuations would add a dimension of uncertainty to trade and investment.

Dollarisation

The term refers to the substitution of the domestic currency with that of a foreign currency as legal tender. This move is only carried out in extreme circumstances where confidence in the domestic currency has been severely battered. The move towards dollarization involves significant technical and legal issues and is difficult to reverse. Additionally, seigniorage, the revenue earned on the reserve assets backing the monetary base, is lost.

With the above arguments taken into account, the HKMA feels that the current peg system is still the best for the territory for the time being. As further reinforcement of that view, the HKMA points out that Hong Kong has not suffered severe economic repercussions as a result of the arrangement:

Figure 10: Hong Kong Exchange Rate and real GDP growth



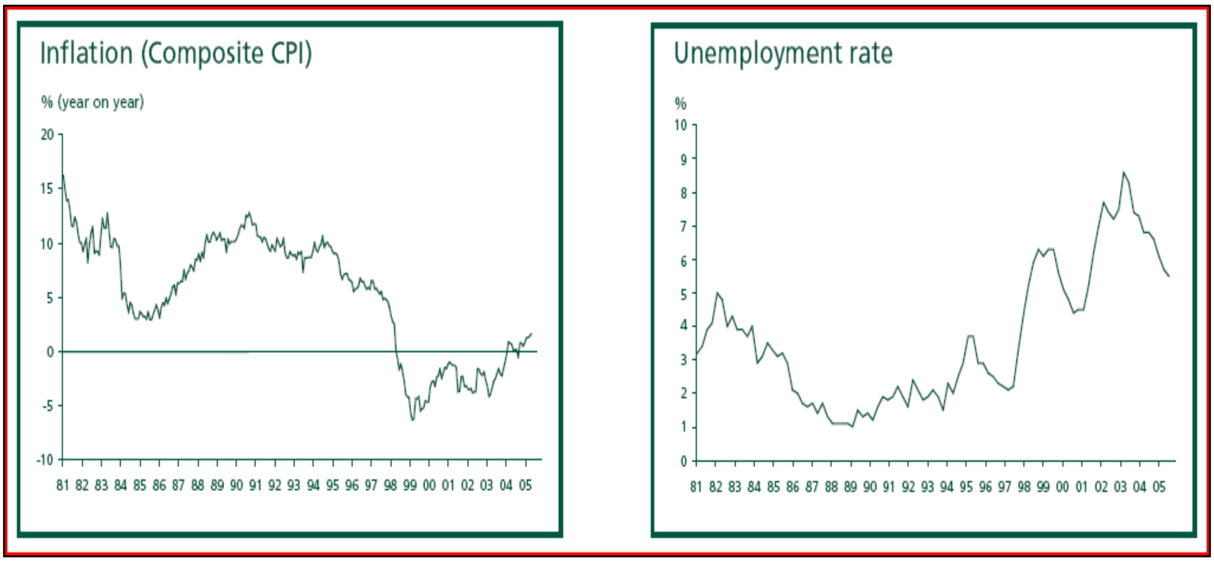
Source: (Background Brief, HKMA, 2005, pg16)

How one defines “severe” is debatable because even though the real GDP growth of Hong Kong has been positive, as is shown above, the general trend, as seen in Figure 10, has decisively been a downward one:

Figure 11: Real GDP growth of Hong Kong

Source: World Bank WDI database 2011

Figure 12: Hong Kong inflation and unemployment rate



Source: (Background Brief, HKMA, 2005, pg16)

Figure 12 above shows a trend of overall decline in the inflation rate of Hong Kong. This could be a result of imported price stability, which is a characteristic of a fixed exchange rate regime.

4.2 A Comparison of the Case of Hong Kong with that of Namibia

Namibia and Hong Kong are two territories which at first glance are diametrically different. The geographical area of Namibia is over 700 times that of Hong Kong, though the population of Namibia is less than a third of that of Hong Kong. Hong Kong is one of the densest territories on earth while Namibia is the second least dense country in the world. The GDP per capita of Hong Kong is over 10 times that of Namibia, indicating two territories greatly removed not only geography but by the standard of living as well.

On the other hand, both are in linked currency arrangements with other countries and the reasons for such arrangements, as well as alternatives to such arrangements, were explored above.

Both countries have stated stability as a paramount reason for the peg. The HKMA wants to ensure the good financial reputation Hong Kong enjoys and the Bank of Namibia wants to ensure economic stability.

Where the two differ is in the exploration of possible alternatives to the current arrangement, should the need arise.

Table 10: Alternative exchange rate regimes for Hong Kong

Hong Kong		
Alternative	**Pro**	**Con**
A once-off change in the exchange rate	Alleviate pain from nominal price and wages	▪ Undermines the credibility of the monetary authority ▪ Invites speculation on future changes, which will undermine investor confidence
A link to another currency		▪ The currency would not be one most used in trade and financial transactions by Hong Kong ▪ The currency would not enjoy the high confidence Hong Kong has in the US monetary authorities
A link to a basket of currencies	HK economy would be less exposed to shocks from a single currency	▪ Reduced perceived transparency ▪ Reduced public confidence in monetary authority
A free-float system	Will allow the HKMA autonomous monetary policy	▪ Vulnerability to international capital flows ▪ Currency fluctuations would lead to trade and investment uncertainty
Dollarisation		▪ Technically and legally difficult to implement ▪ Difficult to reverse ▪ Seigniorage lost

The HKMA, taking the reasons stated in table 10 into account, found more reasons to keep the current arrangement than to break it, even though the arrangement has been in place for close to three decades. One of the reasons the HKMA moved away from the free-float system of 1974 was a monetary authority which lacked sophistication in overseeing its financial ward. The question of the level of the desired "level of sophistication" was not approached.

The Bank of Namibia explored the following options and weighed them as such:

Table 11: Alternative exchange rate regimes for Namibia

Namibia		
Alternative	**Pro**	**Con**
A link to a basket of currencies comprising the Rand and SDR	▪ Reduces impact of Rand volatility on Namibia ▪ Namibia's other trading partners included	▪ Technically more difficult to administer than current arrangement
A link to a basket of currencies based on trade weights	▪ Reduced impact of Rand volatility on Namibia	▪ Great technical skills required ▪ Not transparent
A single peg link to another currency		▪ South Africa is currently the major trading partner of Namibia

On balance, the Bank of Namibia also found more reasons to keep rather than break the current arrangement, as table 11 indicates. Implicit in the conclusion is the fact that the region is moving towards greater integration.

While the HKMA has demonstrated the robustness of the HK$ despite external shocks, the case of Namibia during the GFC illustrates that there will be occasions when the extent of external shocks to the two partners will be too different to warrant an identical monetary policy response. As a possible contingency to such an event, the Bank of Namibia advices exploring other exchange rate arrangements, though none of the options it put forward is a free floating system (table 11).

By surrendering their monetary policy, the two territories will have little recourse, in the form fiscal policy (though this is in the hands of the government, not monetary authority), should they feel that the monetary policy decision taken by their anchor countries is counter to the best interests of their territories. Nevertheless, because of their links to the Federal Reserve (the central bank of the largest economy in the world) and South African Reserve Bank (the central bank of the largest economy in Africa) respectively, Hong Kong and Namibia continue to be associated with the credibility earned by and afforded to the two institutions.

Blanchard (2006) noted that the choice of exchange rate regime matters only in the short-term, as in the medium and long term prices are flexible. Yet, Namibia and Hong Kong have been employing a fixed exchange rate system for 21 and 28 years respectively, with neither territory giving any indication to a change in the current status quo.

5. Conclusion

This paper set out to investigate the academic conditions under which countries choose to peg their currencies to that of another. Although numerous examples of currency linking exist, the paper sought to compare the case of Namibia with that of Hong Kong, precisely because the two territories are so different in the structure of their economies, geography, economic prosperity, histories and social make-up, in order to determine whether there exist reasons for linking which are universal.

After the literature review, a comprehensive background was presented on the history of Namibia to put its current economic relationship with South Africa into context. It was noted that the Bank of Namibia felt that financial stability is of great importance and that the current currency regime helped achieve that.

The exchange rate arrangement which Namibia has with South Africa was examined against textbook justifications for a fixed peg and the most convincing arguments for the peg turned out to be that of close trade relations and political relationships within the region. The reasons of synchronised economic cycles and free factor mobility, as posited by Robert Mundell in 1961, could not be convincingly demonstrated. Additionally, the point relating to the (lack of) credibility of the monetary authority could also not be convincingly argued as the Bank of Namibia had thus far not experienced political interference in its decision making process and has legal safeguards in place to protect it from such interference. Additionally, it was shown that the bank continuously strives for open communication with the public, which helps build the trust of the public in the bank.

After the section on Namibia the paper presented a brief overview of Hong Kong, with the section concentrating primarily on why the territory chose to link its currency to the USD and why it continues to do so. It emerged that the safeguarding of the financial sector is the paramount goal of the HKMA and the authority has found no other exchange rate regime which can safeguard this mandate better than the current arrangement without entering into the risk of currency volatility.

Finally, the cases of Hong Kong and Namibia were compared. It was shown that both conducted research into alternative exchange rate regimes and both concluded that the current arrangements suited for their purposes, which includes financial stability for Hong Kong and creating a stable environment in order to achieve broader national goals for Namibia. When both decided to adopt a fixed currency exchange rate regime (in 1983 for Hong Kong and in 1990 for Namibia), one of the reasons which was forwarded by both was an unsophisticated monetary policy framework, yet none of the two have explicitly stated what they considered an “acceptable level” of sophistication which would no longer warrant the current exchange rate agreements.

It was noted that although the GDP of Namibia trended in a more stable manner (neither upwards nor downwards overall), that of Hong Kong indicated a trend downwards. Thus, even though the two employ the same type of exchange rate regime, the macroeconomic indicators were not necessarily the same in trend or magnitude. Overall, both the HKMA and Bank of Namibia have not indicated that, after over 20 years of operating under a fixed exchange rate regime for both territories, they feel there are reasons which compel them to change the status quo. The global Financial Crisis did demonstrate to the Bank of Namibia that there exist situations where the arrangement might be stressed due to different economic circumstances in the partner countries. Whether conditions might get to the point where the link is severed remains to be seen but as it currently stands Namibia and South Africa, along with other regional countries, appear to be moving in the direction of closer, more integrated ties.

Lastly, it could be concluded that the motivations and benefits of the current arrangement are clearly emphasised by both the HKMA and Bank of Namibia, while the costs of such an arrangement have not been extensively probed. For a more balanced view an in-depth study into the cost of the arrangements, especially over the passage of time, could be instructive.

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